ACCOUNTANCY EUROPE.

BUILDING A CREDIBLE GREEN BOND MARKET

Considerations by the accountancy profession

Position paper

VIEWS.

SUSTAINABILITY
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HIGHLIGHTS

With the European Green Deal, the European Commission sets Europe on a path to become climate neutral by 2050. Achieving this objective will require massive investments. Green bonds are a key tool to help channel funds towards green projects. There is a growing interest in this market but uncertainties remain for issuers and investors.

Our publication presents the accountancy profession's views on how to strengthen the confidence in the green bond market. In light of the upcoming European Union Green Bond Standard (EU GBS) proposal, we recommend to:

- establish a mandatory EU GBS to ensure it is consistently applied in the market
- set up a centralised European accreditation system for external assessment, building on existing national schemes and processes
- require reporting on green bonds and on actual environmental impact at regular intervals
- ensure third-party independent assurance is obtained on allocation and environmental reports
- align the EU GBS with the EU Taxonomy

INTRODUCTION

Europe needs vast investments to become a climate neutral economy by 2050. The existing and forthcoming EU legislation on sustainable finance aims to ensure that more investors shift to green investments. The European Commission (Commission) has put at the centre of its efforts to streamline capital towards sustainable investments. Green bonds are one of the needed financial instruments to channel funds towards environmentally friendly projects.

Since the European Investment Bank (EIB) issued the first ever green bond in 2007, the green bond market has seen rapid growth peaking in 2020 with 269,5 billion USD in global issuance[1]. The green bond market is expected to continue growing – the projections by the Nordic financial banking group (Skandinaviska Enskilda Banken AB) estimate that the global green bonds issuance will reach close to 500 billion USD in 2021. There are also other types of bonds emerging and expected to finance broader sustainability objectives, e.g., EIB's Sustainability Awareness Bond, or transition bonds to finance the shift to a net zero economy.

The figures above show the increasing interest in green bonds as well as the opportunities that this growing market presents. When issuing green bonds, companies diversify investors' base and send a strong, proactive message to a broader stakeholders' group by sharing a positive narrative in public. Green bonds are also well suited for large-scale sustainability projects such as wind and solar development. These often require capital investment ahead of revenues and generate modest revenue over a longer investment horizon.

At the same time, the green bond market is relatively new, still generating uncertainties for green bond issuers and investors. Missing standardisation and a widely accepted definition of what 'green' means brings a high risk of greenwashing – how to ensure green bonds truly finance green projects? Also, could green projects, for instance, coexist with high-intensity carbon emissions investment in a company that issues green bonds? It is equally challenging to measure the investment actual green impact.

The accountancy profession is convinced that opportunities are greater than the challenges. However, further measures need to be introduced to strengthen confidence in the green bond market. In this publication, based on our expertise and experience, we share views on the main matters that will help strengthen this confidence. We specifically refer to standardisation, external assessment[2], regular reporting and alignment with the EU Taxonomy, in the context of EU policy developments.

CURRENT STATE OF PLAY

UPCOMING EU GREEN BOND STANDARD

The Commission is expected to publish a proposal for the establishment of a voluntary EU Green Bond Standard (EU GBS) in 2021. The upcoming EU GBS will certainly bring value to the market as it will introduce a harmonised approach for the green bond issuance within the European Union (EU). However, further legislative steps towards a mandatory standard will be necessary to ensure the EU GBS is consistently applied in the market.

Transparency and standardisation are key to facilitate efficient markets. A credible commonly accepted standard is needed for the green bond market to grow. Investors should be able to trust the green bond market. A mandatory standard would allow investors to have confidence in the underlying assets' environmental quality.

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[1] Climate Bonds initiative, *Green Bonds: Global State of the Market 2019*, see: https://www.climatebonds.net/files/reports/cbi_sotm_2019_vol1_04d.pdf
Bloomberg, see: https://www.bloomberg.com/news/articles/2020-10-30/why-bonds-good-for-the-earth-now-carry-a-greenium-quicktake

[2] Different terminologies are used when referring to green bonds' external assessment. The Technical Expert Group (TEG) on Sustainable Finance uses the term "verification" to describe different types of external assessment. In this publication, we make a distinction between "verification" and "verifiers", and "third-party independent assurance" and "assurance service providers" when referring to external assessment of green bonds.

Also, a common standard can reduce due diligence costs compared to a process of self-certification and decentralised assessments by individual asset managers.

CURRENT APPROACH TO GREEN BOND ISSUANCE

Currently, there is no commonly accepted approach on issuing green bonds and existing market-led initiatives remain voluntary. Such voluntary initiatives include, for instance:

- the market-led initiative Green Bond Principles (GBPs) by the International Capital Markets Association that is built on four components:
  1. use-of-proceeds description: the issuer should appropriately describe the use-of-proceeds in the legal documentation
  2. clear process for project evaluation and selection: the issuer should communicate to investors on the environmental sustainability objectives, the process to determine project's eligibility and the related eligibility criteria
  3. proceeds management: appropriate tracking of the net proceeds
  4. reporting: the issuer should keep up to date readily available information on the use-of-proceeds

  The GBPs recommend having a third-party involved to verify the internal tracking method and the allocation of the proceeds.

- the Climate Bond Initiative (CBI) that outlines pre-issuance and post-issuance requirements, as well as eligibility criteria for projects and assets. There is also a requirement for green bonds certification. In the efforts to better align with the four GBPs pillars, the CBI has recently been updated

Rating agencies have also designed green bond indices and sector-specific standards, which can be used for green bond issuance.

CURRENT APPROACH TO EXTERNAL ASSESSMENT ON GREEN BOND ISSUANCE

As indicated above, there is no commonly accepted approach to green bonds issuance. The same applies to green bonds' external assessment, which can bring confusion to the market regarding the provision of services.

There are currently two types of external assessment on green bond issuance: the second party opinion and the independent third-party assurance. In the table below, we clarify the two approaches' distinctive features. These approaches have different objectives and meaning, and therefore require different capabilities and processes. We further elaborate on the two approaches under the table.

Table: Features of second party expert opinion and third-party independent assurance

Type of review	Second party opinion	Third-party independent assurance
What it covers	Green criteria review; the issuer will use it to select projects for funding	Proceeds management retrospectively throughout the life of the bond In detail: green criteria, project selection and evaluation, internal processes for tracking proceeds, non-financial data on environmental outcomes, and processes for preparing progress reports
Service provider	Environmental expert or consultant	Assurance service providers
Methodology and standards	Methodology and processes developed by individual agencies	In line with national and/or international professional standards such as the International Standard on Assurance Engagements (ISAE) 3000 Revised
Public information	At the consultant's and/or the issuer's discretion	Yes, published by the issuer
Outcome	Opinion by an environmental expert or consultant	Assurance report in line with established professional standards
Limitations	No safeguards around the expert or consultant to secure independence and professional accountability No specific standardised professional requirements (professional qualifications and permanent education) and quality control No standardised processes across experts or consultants based on a publicly available framework	By nature, the information subject to third-party independent assurance is based on past actions, for instance, the fulfilment of criteria can be assured once the terms and conditions have been finalised

A **second party opinion** provides a view by an environmental expert or consultant on green criteria that issuers will use to select projects for funding. Such an approach can be helpful in providing an external party's evaluation of the green criteria used, especially since there is no commonly accepted standard providing clear definitions of "green".

The processes to get to a second party opinion are not standardised, neither are the criteria used to assess the green nature of the project. As the processes are usually not standardised and transparent, they can create inconsistency in the market. There is also usually no framework to ensure independence and accountability of the expert or consultant's performed work. A second party opinion does not aim at addressing whether the bond will be allocated to the type of projects defined nor whether the related assets are managed as promised in the bond's terms. Rather, the environmental expert or consultant gives insights into whether the investments in projects or assets fulfil the criteria to be classified as green on the assumption that the funds are indeed fully invested in the projects or assets as described in the bond's terms.

Third-party independent assurance typically covers the actual management of proceeds and/or environmental impacts throughout the life of the bond. It is conducted by assurance providers in line with national and/or international professional standards such as the International Standard on Assurance Engagements (ISAE) 3000 Revised.

Professional standards ensure that a consistent approach is followed when evaluating a given subject matter and require adherence to quality management and ethical standards. They also require involvement of experts with a high level of knowledge and experience to be able to assess a given subject matter. Furthermore, accountability exists for both the firms and the individual professionals issuing the assurance reports. The approach follows an assurance framework, which includes assessing the overall control environment, including internal controls, and gathering a sufficient set of underlying evidence to reach a conclusion or form an opinion.

When providing third-party independent assurance, the reporting criteria suitability is key as it serves as a point of reference for the assurance provider. A commonly used reporting framework, a standard or a regulation that provide clear definitions are considered as suitable reporting criteria. Therefore, a well-defined EU GBS will not only align terms and approaches used in the green bond market but will also provide a reliable basis to deliver third-party independent assurance.

For green bonds, assurance can be obtained on:

- fulfilment of green criteria
- project selection and evaluation
- internal processes for tracking proceeds
- non-financial data on environmental outcomes
- processes for preparing progress reports

It can also be used retrospectively throughout the life of the bond to obtain assurance on the bond's performance as proceeds are deployed. Providing third-party assurance requires multidisciplinary knowledge and skillset which we further explain in the subsequent section.

IMPROVING GREEN BONDS EXTERNAL ASSESSMENT

Investors need to be able to trust the information provided by issuers, especially when it comes to the allocation of proceeds and the bond's environmental impact. As we note in the previous section, there are different approaches to external assessment of green bonds which can bring confusion to the market.

A CENTRALISED ACCREDITATION SYSTEM FOR GREEN BONDS EXTERNAL ASSESSMENT

We believe it is important to establish a centralised European accreditation system to decrease market uncertainty on the different services provided. Service providers should be formally accredited to ensure their independence, competence and delineation of responsibilities when assessing compliance with the upcoming EU GBS. Equally, such an accreditation system should ensure that service providers have appropriate quality control mechanisms in place to provide hight quality assurance. Creating the accreditation system is also in line with the related recommendation by the Technical Expert Group (TEG) on Sustainable Finance.

At the same time, we do not see the necessity to develop overly detailed requirements for the accreditation system. To avoid duplication of work and unnecessary additional costs, any future European accreditation system should be able to accommodate already existing national schemes and processes. Indeed, certain EU Member States already have well established accreditation systems for third-party independent assurance providers. A European solution should build upon these. Third-party assurance providers already abide by independence rules and have the necessary competence to deal with such matter, involving technical and sectoral expertise, where applicable. The same requirements and principles could be applied to the proposed accreditation system. Below we look into these requirements and principles.

REQUIREMENTS FOR THIRD-PARTY INDEPENDENT ASSURANCE PROVIDERS

PROFESSIONAL STANDARDS

All assurance services providers should be required to apply international and/or national professional standards designed to conduct high quality assurance engagements. For instance, the international professional assurance standard (ISAE 3000) and relevant quality control and independence standards can ensure that assurance providers are independent from the bond issuer, avoiding any conflict of interest. These are also key elements to ensure the assurance engagement's quality.

COMPETENCE AND EXPERTISE

Providing assurance services requires a high level of knowledge and practical experience on a broad range of matters. These include environmental and societal issues, evaluation of controls, risk management and financial audit processes. Depending on the engagement's circumstances other knowledge, including sectoral and technical expertise, may be relevant. When emitting and managing green assets, companies use processes, systems and controls, which are used for risk management, compliance, and corporate reporting. Assurance providers should be able to assess the business as a whole.

It is important to involve experts to ensure a diverse skills base to deliver quality services. The multidisciplinary model is a reliable mechanism to use these skills and expertise. The accountancy profession has acquired the necessary skillset through its long-standing experience in financial statement audit and various other assurance services as well as extensive experience in, not only evaluating the systems and processes in place, but also in providing confidence in their output.

Financial statement auditors are used to assessing the value of assets such as loans, tangibles and intangibles, inventory, etc. Where deemed necessary, specialised auditors or specialists are consulted too. Auditors are also able to distinguish "green" bonds from "brown" bonds, to carry out a valuation of green bonds and issue corresponding valuation opinions.

ETHICAL REQUIREMENTS, INCLUDING INDEPENDENCE

It is essential that assurance providers abide by strong ethical principles and rules, including independence requirements. Independence safeguards the ability to form an assurance conclusion without compromising professional judgement. It thereby allows the service provider to act with integrity, and exercise objectivity and professional scepticism.

The essence of such requirements should be applied to all assurance providers to ensure that no threat to objectivity undermines the service quality. Independence and objectivity are values of utmost importance to ensure that the information provided is indeed reliable. This is even more relevant when it comes to a developing market, such as the one of green bonds, that poses high risks of greenwashing.

The accountancy profession is used to exercising professional judgement and scepticism. This involves attitudes of mind that reflect a determination to do the right thing, having a responsibility to act in the public interest, and not simply to comply with a legal requirement.

PUBLIC OVERSIGHT

Public oversight of assurance service providers is necessary to ensure the above principles and requirements are fulfilled by the service providers. It adds credibility to the provided assurance service. Such a role could be taken up by existing oversight bodies[3] by extending their current mandate. It will also help the liability regime to

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[3] The revised EU statutory audit rules significantly impact how public oversight of the statutory auditors and audit firms is organised. Public oversight ensures audit quality and designated national public oversight bodies have the ultimate responsibility for the oversight of the audit profession. Read more: *Organisation of the Public oversight of the audit profession in 30 European countries*, Accountancy Europe (2020), see: https://www.accountancyeurope.eu/publications/organisation-of-the-public-oversight-of-the-audit-profession-in-30-european-countries/

function properly. However, it is important to establish a system where supervision applies to all forms of external assessment providers. This will ensure the quality and reliability of the services provided.

OTHER CONSIDERATIONS FOR DEVELOPING THE EU GREEN BOND STANDARD

REPORTING & MONITORING ON GREEN BONDS

To ensure that green bonds are credible in the long run, investors and other stakeholders need to be able to trust that the funded projects produce the expected environmental benefits.

Bonds' portfolios can transform over time. Reporting on green bonds should be done at regular intervals during the life of the bond and projects invested in, at least annually after all funds have been allocated to green projects. This will ensure continuing information on the portfolio's current size and the related environmental impact to the market.

Furthermore, according to the latest user guide of the TEG, the use-of-proceeds is expected to facilitate investment in assets or projects within legal entities or across different entities. Although this is valid, disclosures required by the future standard alone may not be sufficient to allow investors to be confident that the proceeds have indeed been used for the 'green' or 'greening' purposes as intended. Financial characteristics of those assets or projects should not be overlooked.

This reporting challenge could be overcome in part by including more granular information in the framework and allocation reports about the use-of-proceeds. That could include, for example, information on the fact that:

- all projects or assets linked with green bond schemes are associated with only one of such bonds, or
- if they are financed by multiple instruments, there are sufficient controls in place to ensure money is not used multiple times for the same investment.

To bring confidence and trust that the funds have been applied for the intended purpose, third-party independent assurance should be obtained on allocation reports. That is also recommended by the TEG in their report on EU GBS. Additionally, the actual environmental impact should also be reported regularly (i.e., annually). Independent third-party assurance should be obtained on the environmental report to confirm accuracy and completeness of the reported information.

Finally, the legislative coherence of the requirements should not be overlooked. Other pieces of EU legislation outline requirements for companies to report on environmental matters: the Non-Financial Reporting Directive 2014/95/EU (NFRD) on non-financial information, including environmental and social matters; and the EU Taxonomy Article 8 on the green revenue and expenditure. Financial institutions will have to comply with specific requirements too. A green bond is a financial instrument, at a product level. But the NFRD and the EU Taxonomy require disclosing of information at a company level. Additional disclosures might be necessary in the future to comply with these requirements or requirements stemming from other relevant legislation, for instance the Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector.

FINANCING THE TRANSITION BEYOND GREEN BONDS

The journey towards a green economy does not consist of the issuance of green financial products only. It also includes investments in assets and projects that drive efficiency to finance the transition to a green economy. For instance, the proceeds of a bond may not necessarily be tied up to a particular project. They could also relate to the issuer's strategy and open the market linked to the environmental, social and governance (ESG) goals. The European Central Bank (ECB) has recently given the green light to sustainability-linked bonds, which is expected to boost the emerging market.

Moving forward, the EU GBS could be used as a basis for gradually expanding the standards to other financial instruments such as transition bonds, sustainability-linked bonds and loans to provide issuers with guidance on disclosures and necessary documentation. Investment opportunities must not be restricted to only issuers operating in already low carbon sectors. These instruments can also help issuers set ambitious targets, for instance, to align their greenhouse gas emission levels with a net zero trajectory.

Consequently, the EU GBS could cover several categories of bonds to fulfil transition financing needs. The first category, as envisaged by the TEG, would include green bonds that are fully aligned with the EU Taxonomy. Alignment of eligible green projects with the EU Taxonomy would reduce uncertainty on what to consider green and provide clear guidance. This would also lead to more eligible green projects for investments.

However, the EU Taxonomy rigid application to the EU GBS might not fulfil technical screening criteria for every investment and could result in limiting green bond issuance to project-based investments. In other words, this could lead to narrowing down the scope to best performers excluding those that are making progress in transitioning towards a net zero economy. The EU GBS could then be expanded to cover another category to finance transitional economic activities. It would provide guidance on issuing transition bonds with more flexible application of the EU Taxonomy, while respecting its fundamentals.

Any proposed legislation should not leave behind the issuers that are willing to go through the transition, but that have not reached their targets yet. The EU GBS and its alignment with the EU Taxonomy Regulation, as described above, can provide the right incentives to achieve that. Market driven solutions should not be neglected as a transitional way forward either. Benchmarking issuers and their activities based on performance (above market average) can allow issuers to proceed with a ‘transitional’ green bond.

CONCLUSION

Massive investments are needed to finance the transition to a net zero economy. The green bond market has been rapidly growing together with other types of emerging bonds to finance broad sustainability goals. Transparency and standardisation are key features to facilitate efficient markets. The upcoming Commission’s proposal to establish the EU GBS is expected to bring harmonisation in the green bond market. Further legislative steps will still be necessary to ensure consistency in the EU GBS application, but also with other standards to be developed for other sustainable financial products.

Investors should be able to trust the information provided by the issuer. A mandatory EU GBS standard would allow investors to have confidence in the underlying assets’ environmental quality. Such a standard should have a requirement to align with the EU Taxonomy to reduce uncertainty as to what should be considered as green. Obtaining independent third-party assurance on various aspects, including allocation reports, but also on environmental reports could further help enhance investors’ confidence.

Finally, all assurance service providers should comply with equivalent professional standards, thus strengthening investors’ confidence in the reliability of the assurance reports they receive. For that reason, a centralised accreditation system for assurance providers at European level should be considered. Such a system should build on already established national schemes and processes.

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